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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1882.

(No. 1151.)

THE UNION TRUST COMPANY OF NEW YORK,
Appellant.

vs.

EDWARD FITZGERALD.

APPEAL FROM THE CIRCUIT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF ILLINOIS.

STATEMENT OF THE CASE BY COUNSEL FOR APPELLEE.

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The facts in this case are identical with the facts in the case of this appellant *vs.* John Walker, No. 1150, except that in this case the appellee personally performed the labor for which he filed his intervening petition.

On the 2d of October, 1871, "The Cairo and St. Louis Railroad Company," a corporation, under the laws of Illinois, organized to build a narrow-gauge railroad from St. Louis to Cairo, issued two millions and five hundred thousand dollars of bonds, bearing seven per cent. interest, payable semi-annually, and secured them by a deed of trust on the road it proposed to build, and all its after acquired property.

One Henry W. Smithers, representing capitalists, as their agent, purchased the bonds direct from the com-

pany at a large discount on their face value, and became possessed of all of them about July, 1872. (See his testimony in the case of this appellant v. E. E. Souther & Bro., No. 1152, in this court, used in this case by stipulation of counsel.)

Smithers looked closely after the investment made for his principals. The railroad company obtained aid in bonds from the city of Cairo, and from Alexander County, Illinois, and from other sources. On the 1st of October, 1873, the railroad company made default in payment of interest. It paid Smithers three thousand dollars at one time for forbearance of interest for two years; but, as he states, it was in fact applied on account of his salary as agent of the bondholders. The railroad was finished in 1874, and it was about that time that the $3,000 was paid. Smithers stood by and did nothing till December 6, 1877, when the proceeding for foreclosure was instituted. After about January, 1877, the railroad company ceased, in a great measure, to pay the laborers engaged in operating the road, and ceased to pay for supplies so far as they could be obtained on credit. The earnings were applied to making permanent and lasting improvements on the road. Handsomely engraved meal tickets were made and issued to laborers in payment of their labor, and for circulation among the employees, and other schemes and devices were adopted to put them off. Finally, on the 6th of December, 1877, the Circuit Court of the United States for the Southern District of Illinois, on the application of the trustee of the bondholders, this appellant, appointed the same Henry W. Smithers receiver of the road. The order and decree appointing him imposed the condition that the labor done and supplies furnished within the next preceding six months, by which the road had been kept running and preserved for the bondholders, should be paid out of the net earnings of the road. (See printed Record, p. 2.) No ob-

jection to that provision or condition of the order was heard at the time, but Smithers at once, under that order, took possession of the road and its property as receiver, and continued to operate the road as such receiver up to January 31, 1882, a period of *four years and upwards.*

It was proven (see printed record, p. 3) that the net earnings of the road during the receivership were more than sufficient to pay all claims for labor and supplies of the class embraced in the condition or provision of the decree appointing the receiver, but were diverted to the purchase of depot grounds and rolling stock, etc.

Not until May 16, 1881, was the decree of sale entered. It was then found that the principal and interest due on the bonds amounted to $4,301,157.53. The commissioner reported the sale on the 14th of July, 1881, for four million dollars, which was paid in the bonds and coupons secured by the deed of trust. The order of sale required the payment of $100,000 on bidding off the property. On the 12th of December, 1881, the report was approved and the sale confirmed. On December 22, 1881, the court ordered a deed to be made to the purchasers conveying the road and property, "sub- "ject to the lien of any and all claims against "said railroad property and assets which are now "before this court by intervening petitions, and which "shall, upon final determination and adjudication, be "decreed to be paid as liens paramount to the indebted- "ness secured by said deed of trust." The deed was made accordingly on the 30th of January, 1882, and the possession delivered by the receiver on the following day.

Appellee, who was a locomotive engineer, and who had been in the employ of the rail-road company in that capacity up to to the date of the appointment of the receiver, had due him, from the railroad company, for wages for labor, in operating said railroad, within six months

preceding the date of the appointment of the receiver, the sum of three hundred and thirty two dollars and twenty eight cents, and on June 4th, 1878, filed his intervening petition therefor in said court.

On a reference to a special master, the facts were so found and reported, and on the hearing the court approved the report, and on the 27th of October, 1882, made the final decree ordering the payment of his claim as set out at page 4 and following of the printed record.

A division of opinion was certified as to the two questions as set out on pages 3 and 4 of the printed record, and the trustees of the bondholders bring the case here by appeal.

APPELLEE'S ARGUMENT.

The questions certified on division of opinion from the Circuit Court, as stated in the printed record, page 3 and 4, have been fully considered, passed upon and answered by this court in the case of Fosdick v. Schall, 99 U. S., 252, and Hale v. Frost, 99 U. S., 391.

The questions certified may be considered together, the first and second questions differing only in this: that while the first involves only the power to make the order in favor of the laborer; the second is general in its character as to the power of the court to make the order in this particular case.

The answer to these questions involves these points:

1st. Is the income earned by the road after the appointment of the receiver applicable by a Court of Chancery to the payment of debts for labor, which accrued prior to such appointment.

This court, in Fosdick v. Schall, 9 Otto, p. 252, has declared "that every railroad mortgagee, in accepting "his security, impliedly agrees that the current debts

"made in the ordinary course of business shall be "paid from the current receipts before he shall have "any claim upon the income."

And in the same case, on page 251, this court says: "The possession taken by the receiver is only that of "the court whose officer he is, *and adds nothing to the "previous existing title of the mortgagees.* He holds, "pending the litigation, for the benefit of whomsoever, "in the end, it shall be found to concern," *and in the meantime the court proceeds to determine the rights of the parties upon the same principles it would if no change of possession had taken place.*

In the case of Hale v. Frost, 9 Otto, page 391-2, this court, while deciding that the railway mortgage is a prior lien only upon the net earnings of the road after the payment of all the operating expenses while the road is in the possession of the company, also decided: "That the net earnings of the road, while in the possession of the court and operated by its receiver, are not necessarily and exclusively the property of the mortgagees, but are subject to the disposal of the chancellor in the payment of claims which have superior equities, if such shall be found to exist," and that certain claims for car-springs, etc., supplied shortly before the receiver's appointment, and continued to be used on the road by the receiver, as well as certain supplies for the machinery department, had superior equities to those of the mortgagees, but denied the superiority of the equities of a claim for materials for construction under the particular circumstances. This was a case where the bondholders funded their interest coupons and allowed the company to retain possession after default."

In Fosdick v. Schall, *supra*, it was also said, on page 252 that if, for the convenience of the moment, something is taken from what may not improperly be called the current debt fund, and put into that which belongs to the mortgage creditors, it certainly is not inequitable

for the court, when asked by the mortgagees, to take possession of the future income and hold it for their benefit to require, as a condition for such an order, that what is due from the earnings to the current debt shall be paid by the court from the future current receipts before anything derived from that source goes to the mortgagees. In this way the court will only do what, if a receiver should not be appointed, the company ought itself to do.

This court also declared in the same case, page 253, that if no order (meaning conditions in the decree appointing the receiver) is made when the receiver is appointed, and it appears in the progress of the cause that bonded interest has been paid, additional equipments provided, or lasting improvements made *out of earnings which ought in equity* to have been employed to keep down debts for labor, supplies and the like, it is within the power of the court to use the income of the receivership to discharge obligations which, but for the diversion of funds, would have been paid in the ordinary course of business * * * because, in a sense, the officers of the company are trustees of the earnings for the benefit of the different classes of creditors and the stockholders, and if they give to one class of creditors that which properly belongs to another, the court may, upon an adjustment of the accounts, so use the income which so comes into its own hands as, if practicable, to restore the parties to their original equitable rights. * * * The power rests upon the fact that in the administration of the affairs of the company the mortgage creditors have got possession of that which in equity belonged to the whole or a part of the general creditors. Whatever is done, therefore, must be with a view to a restoration by the mortgage creditors of that which they have thus inequitably obtained. It follows, therefore, that if there has been in reality no diversion, there can be no restoration, and that the amount of the restoration

should be made to depend on the amount of the diversion.

The court also says, in the same case, page 252, that "the income out of which the mortgagee is to be paid, is the net income obtained by deducting from the gross earnings what is required for necessary operating and managing expenses, proper equipment and useful improvement.

In Poland v. The R. R. Co. *infra*, it is decided that where default is made, and, as in this case, the mortgagees fail to take steps, at once, to enforce their rights under the mortgage, but permit the mortgagors to retain possession and control of the road and its income, equity will consider labor, etc., done and furnished from that time until the mortgagees take such action, as done for the benefit of the mortgagees and of so much advantage to their security; and that claims for such services will therefore be considered as giving the claimants a superior equitable claim on the earnings to that of the mortgagees.

Fosdick v. *Schall, supra; Galveston R. R* v. *Cowdry*, 11 Wall, 482–3; *Gilman* v. *Ill. & Miss. Tel. Co.*, 1 Otto, 616–17; *America Bridge Co.* v. *Heidelboch*, 94 U. S., 800, *Booth* v. *Clark*, 17 How., 331 and 2.

From these declarations of law made by this court, we conclude that the earnings, both before and after the appointment of the receiver, were applicable to the payment of the claims at bar for labor done before such appointment, and the mortgagees had only a claim to such net earnings as might remain in the receiver's hands after payment of all such claims for operating expenses up to the date of the decree—for they could have no higher claim on such income in the hands of the receiver than they had upon it in those of the company; the appointment of the receiver changed the possession but not the rights of the parties. The rights of the intervenors, therefore, continued at least until the

decree of foreclosure and sale. It would be extremely inequitable to say that the mortgagees could, by asking the exercise of the extraordinary powers of a Court of Chancery, free themselves from their implied agreement that such claims should be paid from the earnings before they should have any claim upon the income. And this is true upon general equitable principles, although no order may have been made at the time of appointing a receiver, as a condition of the appointment, for the payment of such claim.

In the well considered case of *Poland* v. *Railroad Company, 52 Vt. 144*, this same conclusion was reached, and is supported by the following cases :

Douglass v. *Cline, 12, W. P. D. Bush, p. 609; The Syracuse City Bank* v. *Talleman, 31 Barb. 209; Duncan* et al. v. *Trustees Chesapeake & Ohio Railroad, 3 Cent. L. J., 579; Atkins & Co.* v. *Petersburg R. R. Co., 3 Hughes* (*Va. Rep.*), *316, etc.* and cases cited in those references; *Ellis* v. *Boston, etc. R. R., 107 Mass., 28-9. Clay* v. *East Tenn. & Virg.* R. *R. Co.* 6 Heisk., 431.

But this court has said, in the case of Fosdick v. Schall, 9 Otto, page 251-2, that it has "no doubt that when a Court of Chancery is asked by railroad mortgagees to appoint a receiver of railroad property, pending proceeding for foreclosure, the court, in the exercise of a sound discretion, may, as a condition of issuing the necessary order, impose such terms in reference to the payment from the income during the receivership of outstanding debts for labor, supplies, equipment or permanent improvement of the mortgaged property as may, under the circumstances of the particular case, appear to be reasonable."

It also says "that the chancellor should so mold his order that, while favoring one, injustice is not done to another."

To the same effect are the following cases:

Poland vs. Railroad Co., 52 Vt., 176, &c.; Douglas vs. Cline, 12 Bush (Ky.), 609; Duncan et al. vs. Trustees, &c., 3 Cent. L. J., 579; Gurney v. Atlan. & G. W. Ry. Co., 58 N. Y. 366; Syracuse City Bank vs. Tallman, 31 Barb., 201; Nichols vs. Perry Patent Arms Co., 3 Stock. (N. J.) 126.

Here is authority, for including in the decree granting the receiver, the clause providing for the payment of claims for labor and supplies which accrued in operating and maintaining the road within six months immediately preceding the decree.

The only question is, was the condition thus imposed a reasonable one? Of this there is no doubt; the men thus protected had contributed to the preservation of the value of the security of the bondholders and to the preservation and the probable increase of the value of its earnings; their claims had accrued so recently that they could not be claimed to be stale, and the decree about to be made would cut off their right to proceed against the property of the company at law.

If the court rightfully made this order, then those in whose favor it was made have a right to demand that it be enforced.

2d. If without an order, in the decree appointing the receiver, these claims could and should have been paid out of the net earnings of the receivership, as it seems it has been shown they can, or if the order in the appointing decree is valid, then the mortgagees received, in the net earnings applied under the orders of the court to purchase additional property and equipment for the road, the fund from which claimants in equity and under the order of the court should have been paid, leaving no fund out of which to pay such claims, and that not merely to preserve their security in *statu quo*, but

to add to and increase it. This was a diversion of the current debt fund, and presumably increased the proceeds of sale to the extent of such diversion. The amount so diverted, equity will compel to be restored from the fund receiving the benefit. The amount of diversion amounted to more than enough to pay these claims. Therefore, these claims are equitably chargeable against the fund in the registry arising from the sale, and can be ordered paid therefrom.

Fosdick v. *Schall*, 9 Otto, p. , and authorities *supra*.

The mortgagees, being the parties entitled to the proceeds of sale, applied for the receiver. Their application was granted on condition that the receiver they asked for should, after paying expenses of his administration, pay these claims and others like them, out of the net income of the road. They accepted the receivership under the decree so conditioned without objection at the time, had their own agent appointed receiver under it, had this receiver apply the net income with the acquiescence of the court, so that the value of the mortgaged property, and, consequently, the proceeds of sale, were increased thereby. Having done this, they will not now be permitted in a court of equity to say either that the clause in the decree appointing the receiver, which provides for the payment of these claims, is not proper, just and valid, or that the proceeds of sale are not chargeable with the amount diverted.

Douglas vs. Cline, 12 Bush, sup.; Wallace vs. Loomis, 7 Otto, 162-3; Railroad Co. vs. Soutter, 2 Wall, 511; Fosdick vs. Schall, 9 Otto, 253.

In conclusion, counsel for appellee submits that the record and proceedings to which he has a right to refer in this argument lead to the conclusion that, from the inception of the enterprise of building this road, there appear to have been close relations between the company and the bondholders; Smithers certainly represented the bondholders and knew all about the company at

every stage of its existence. There does not appear at any time any conflict of action between the company and its bondholders or their agent. Who composed the railroad company, or had any interest in the road at any time, except the bondholders, has not been made to appear in the proceedings in this cause. The solicitors for the bondholders were, to all appearances, the solicitors of the railroad company, for the receiver, for the trustees of the bondholders, and, in fact, for everybody concerned, except the men who had preserved the road and property for the bondholders by keeping it in operation.

The latter were not consulted as to the application of the net earnings in the receiver's hands, and among the former there was, of course, under the circumstances, no difference of opinion as to the propriety of putting the earnings into depot grounds and permanent improvements, instead of paying the laborers, as the order of the court required the receiver should do.

The receiver kept the road in his possession, operating it as receiver for upwards of *four years*, while the coupons on the bonds which he represented were maturing and interest accumulating on those already matured, thus aggregating interest to make up the required four millions of dollars, and all through these years this claimant was getting no interest on the money he had toiled for by day and by night, and at the risk of his life every hour.

The net earnings of the road while in the hands of the receiver, amounting to about two hundred and fifty thousand dollars, were used in buying valuable grounds for depot and other purposes, in East St. Louis and elsewhere, and in equipping the road with fine rolling stock, and in filling trestle-work with earth, and in making other valuable and lasting improvements for the benefit of the purchasers of the road: the bondholders who paid for it

in the bonds. The whole amount of the claims for labor and supplies, which the claimants had the good fortune to file intervening petitions for within the time limited by the order of the court does not aggregate $65,000, while the diversion of earnings in excess of expenses of the receivership, including about fifty thousand dollars applied to payment of receiver's salary and extra compensation and his solicitor's fees, amounts to thrice the aggregate of all claims of intervening petitioners for labor and supplies. Appellee insists that, under all the facts and circumstances of this case, the appellant has no standing in a court of equity to question the power of the court to require this claim to be paid out of the proceeds of the sale in its registry, or to be hereafter paid into the registry on that account.

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